

BUSINESS ENTITIES & IMPLICATIONS

BUSINESS ENTITY PLANNING

- When planning for Farm or Ranch succession one of the first decisions that must be made is the legal organization of the operation
- The decision will involve both the type of entity and the number of entities
- This decision will have both business and estate planning implications
- What will be good for one area may have adverse consequences in the other – it is important to consider the impact of decisions in both areas

BUSINESS OWNERSHIP

- Sole Proprietorship
- Partnerships
 - General Partnership
 - Limited Partnership
- Limited Liability Company
- Corporations
 - C Corporation
 - S Corporation

CHOOSING THE RIGHT ENTITY

- Primary factors driving the choice of entity decision...
 - Tax considerations
 - Asset protection
 - Flexibility
 - Integration with estate plan
 - Farm program requirements

BENEFITS OF A FAMILY BUSINESS ENTITY

- Gifts of economic increments can be conveniently made
- Substantial gifts can be made without loss of control
- Discounting
- Family members may be involved and educated in management of assets
- Limit management to selected owners
- Can include buy-out terms upon the occurrence of triggering events such as death, disability, divorce, disagreement, etc.

BENEFITS OF A FAMILY BUSINESS ENTITY

- Income may be shared among family members
- Limits the exposure of the family to outside creditors and failed marriages
- Administration of the assets held by the entity at the death of the parents is simplified

SOLE PROPRIETORSHIP

- Simplest form of business organization
- Requires no formal written documentation other than basic farm/ranch financial, & tax records
- The owner owns and manages the business, assumes all risks, receives all profit
- Taxes on profit paid at tax rate of owner (individual or joint for couple)
- Advantages: simplicity, same tax return, same SSN
- Disadvantages: personal liability, lack of continuity, lack of real structure

SOLE PROPRIETORSHIP



God makes the snake

GENERAL PARTNERSHIP

- Easy to establish
- The association of two or more persons to carry on as co-owners a business for profit forms a partnership, **whether or not the persons intend to form a partnership**
- With some exceptions, the partnership agreement will govern the affairs of the partners
- Each general partner is personally liable for debts & obligations of the partnership

LIMITED PARTNERSHIP

- Formal formation requirements
- Requires a general partner and one or more limited partners
- Limited partners only have financial interest – no management rights
- No liability for limited partners
- Unlimited liability for general partner
- Partnership agreement will govern affairs of company

CORPORATIONS

- Formal formation requirements
- Perpetual existence
- All owners have limited liability protection
- Taxed as S Corp or C Corp

CORPORATIONS – TAX ISSUES

- A farm corporation is a "farmer" for most income tax purposes
- Most special income tax elections available to an individual farmer, partner or farm partnership are available to a farm corporation

C CORPORATIONS

- This is the default classification
- Double taxation
- Fringe benefits

S CORPORATIONS

- Shareholders must elect to be taxed under Subchapter S
- No more than 100 shareholders
- No shareholder may be a nonresident alien or individual married to a nonresident alien
- S corporations can have only one class of stock.
- Pass through entity
- Used to minimize SE taxes

LIMITED LIABILITY COMPANY (LLC)

- Formal formation requirements
- Perpetual existence or less by agreement
- May have one or more members (similar to shareholders) who own the membership units (similar to shares)
- All members have limited liability
- Operating agreement governs relationship of the members – extremely flexible
- Taxed as a disregarded entity, partnership, S Corp., or C Corp.

LIMITED LIABILITY COMPANY (LLC)

- Charging order vs. foreclosure
- Single member LLC
- Most flexible option
- Has become the most common form of business

OWNERSHIP OF REAL PROPERTY

- **Generally, don't want real property in an entity taxed as a corporation**
- **When the property comes out it can trigger gain**
- **Contribute real property into an entity taxed as a partnership and you have flexibility - you can always undo your previous decision and distribute without recognizing gain at either the entity or individual level**

WRITTEN PARTNERSHIP/OPERATING AGREEMENT

- **Management**
 - Who is responsible for which decisions and how they shall be made
- **Property**
 - List the property each partner will contribute and how it will be owned
- **Share of profits and losses**
 - Carefully describe how these will be divided
- **Records**
 - Designate who will keep the records

WRITTEN PARTNERSHIP/OPERATING AGREEMENT

- **Taxation**
 - Include a detailed account of tax basis of property and copies of the partnership information tax return
- **Transferability**
 - Addresses when and how owners can sell ownership interest
 - Addresses purchase price for buyout
 - Trigger events
- **Termination**
 - State the date of termination unless perpetual
- **Dissolution**
 - Method of division of property in case of dissolution of partnership

FORMING A FARM BUSINESS

- Reserve name for the entity
- Draft a pre-incorporation/organization agreement outlining major rights and duties of the parties
- Prepare and file the appropriate formation documents with the State
- Prepare other appropriate agreements
- Transfer property or cash to entity in exchange for ownership

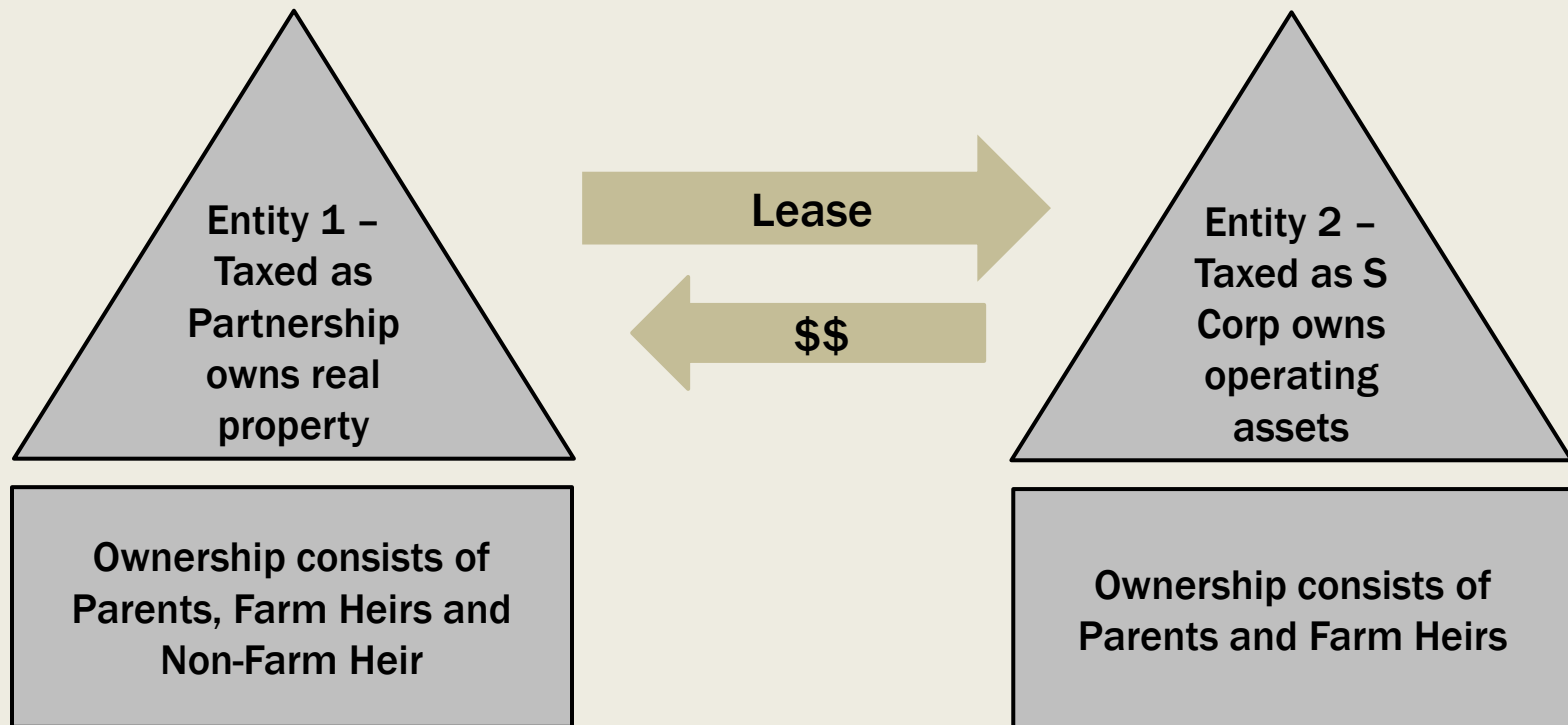
PIERCING THE VEIL

- For LLCs and Corporations an owner's personal assets are generally protected from the claims of company creditors
- This protection can be lost through improper management
- Co—mingling of funds is one of the biggest concerns
 - Maintain separate personal and business accounts
 - If the company needs money- make a documented loan from personal monies to the company
- If you want the court to honor the separate entity status, you need to as well

MULTIPLE ENTITIES

- Can be simple or complex based upon the needs of the Farm Family
- Provides for separation of investment interests from management and control
- Greater liability protection
- Provides income splitting option for better tax results

MULTIPLE ENTITIES - HOW IT WORKS



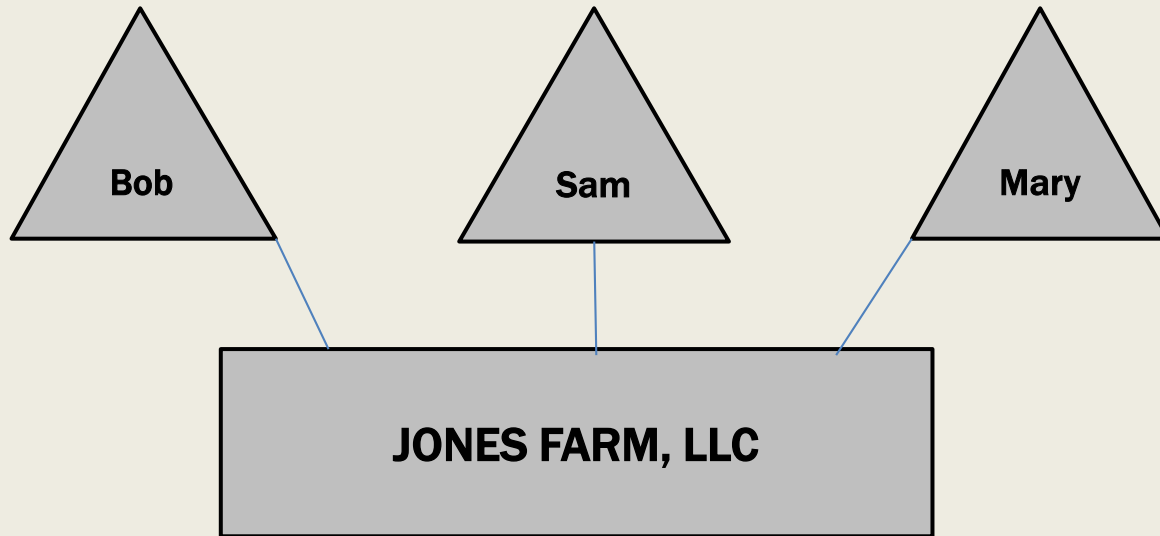
FARM PROGRAM REQUIREMENTS

- The requirements of applicable government programs should be reviewed when forming a farm business entity
- Per person limitations exist for various programs
- Actively engaged requirements

FARM PROGRAM REQUIREMENTS – CRP EXAMPLE

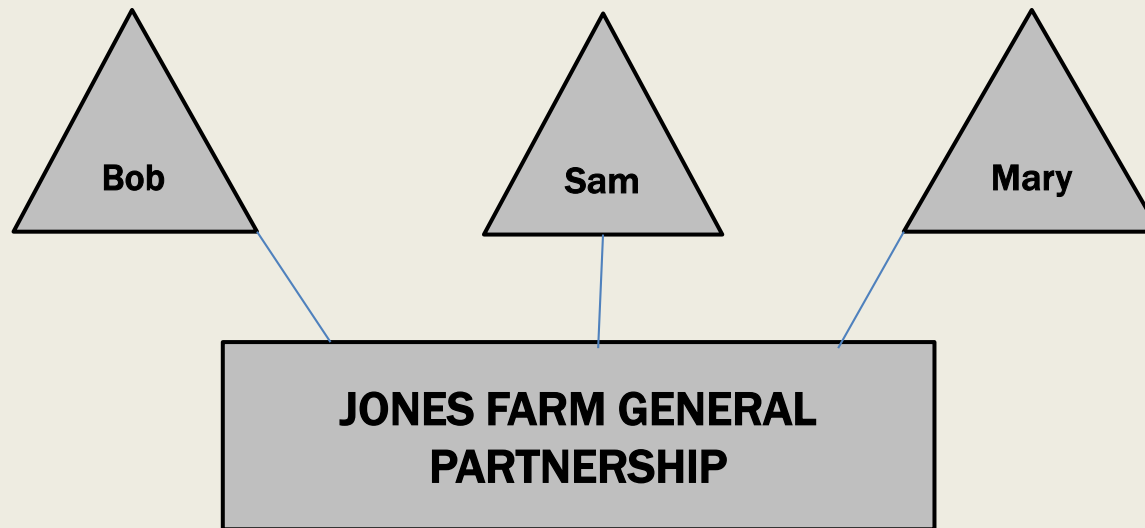
Jones Farm has three owners who are siblings. Bob Jones has an AGI of \$400K, Sam Jones has an AGI of \$600K, and Mary Jones has an AGI of \$600K. The current per “person” limitation for CRP is \$50K. Based upon the FSA calculations there is a potential of \$120K in CRP money available for the Jones Farm land.

FARM PROGRAM REQUIREMENTS – CRP EXAMPLE



Jones Farm LLC can only qualify for one CRP of payment of \$50K to be divided three ways assuming the LLC does not exceed the \$900K AGI cap. Not eligible to receive the additional \$70K.

FARM PROGRAM REQUIREMENTS – CRP EXAMPLE



Each partner of the Jones Farm GP will qualify for up to \$50K. Individual AGI does not exceed the \$900K cap. Full \$120K will be divided 3 ways. Consider forming separate single member LLC's to be partners in the GP.

BUSINESS DOCUMENTS NEEDED

- **Bylaws**
- **Management agreement**
- **Leases**
- **Employment agreement**
- **Non-competition**
- **Retirement plans – Qualified and Non-Qualified**
- **Partnership agreement**
- **Operating agreement**
- **Buy-sell agreement**

QUESTIONS?